# Selected U.S. Tax Developments

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## PROPOSAL BEFORE CONGRESS TO DEFINE U.S. RESIDENT STATUS

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*The two ranking members of the House Ways and Means Committee have proposed legislation containing a new statutory definition of resident alien. This proposed definition is a radical departure from the pre-existing case law approach and if enacted will treat many more aliens than before as U.S. resident aliens. Because there are significant direct and collateral consequences of being classified a U.S. resident, every tax adviser should be aware of the proposed new definition.*

Under existing law, an alien is not regarded as a resident of the United States unless he is present in the United States with an intent to stay for an indefinite period. Thus, in the absence of other circumstances, the mere ownership of or making an application for a "green card" generally is not considered sufficient to constitute an alien a resident. Similarly, absent other factors, presence in the United States for 183 days or longer during a calendar year is not determinative of residence. Nor is the ownership of a place of abode in the United States determinative of the issue. Rather, all of the facts and circumstances of an alien's presence are considered in order to determine whether it is more or less likely that he had an intent to reside in the United States for an indefinite period.

On June 30, 1983, the two ranking members of the Ways and Means Committee introduced in the House of Representatives the Tax Law Simplification and Improvement Act of 1983 (the "Act").[1] Section 501 of the Act would add to the Internal Revenue Code (the "Code") as new section 7701(b) a definition of "resident alien" that would substantially broaden the class of aliens who would be regarded as residents of the United States for income tax purposes

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[1] It may be possible to trace the impetus for this legislation to a 1982 proposal by the Section of Taxation of the American Bar Association for such a statutory definition of residency. The ABA proposal was, however, significantly more liberal than proposed section 501.

This new definition could adversely affect an alien who considers himself a "nonresident" of the United States if (1) he has in his possession or has applied for a "green card," (2) he spends 183 days or more in the United States in any calendar year, *or* (3) he spends a lesser but still significant amount of time in the United States and has an "abode" in the United States. In these cases, an alien will be regarded as a resident for U.S. federal income tax purposes regardless of any other facts and circumstances relating to the alien's presence in the United States. The new definition will not affect the determination of whether an alien will be regarded as resident for the purpose of U.S. estate or gift tax. Residence for U.S. estate and gift tax will continue to mean domicile as under existing law.

## EFFECT OF RESIDENT CLASSIFICATION FOR ALIENS

Whether an alien is considered a resident or nonresident for U.S. income tax purposes is of considerable tax significance. Most obvious, a resident alien generally is subject to U.S. federal income tax on his worldwide income. In certain circumstances, this includes the undistributed income of foreign corporations that are controlled by U.S. residents. There also are several other collateral effects. Thus resident aliens may incur U.S. tax on certain transfers of appreciated property to trusts and they are subject to a number of filing requirements generally not required of nonresident aliens. Moreover, classification of an alien as a resident may have an effect on others; it may, for example, have an effect on whether a corporation in which the alien or any person "related" to him owns an interest qualifies as a "controlled foreign corporation," a "foreign personal holding company," or a "personal holding company."

In certain cases, an alien who is a resident of a country with which the United States has an income tax convention and who is also a resident of the United States under U.S. internal law may, *for purposes of the treaty,* be regarded as resident only in the treaty country.[2] That does not necessarily mean that he will not be regarded as a "resident" of the United States *for purposes not covered by the treaty.* For example, the determination that the alien is a U.S. resident under U.S. internal law may still affect the classification of a foreign corporation as a controlled foreign corporation,[3] a foreign personal holding company, or a personal holding company.

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[2] See, for example, the pending Convention Between the United States of America and Canada with Respect to Taxes on Income and Capital (the "pending treaty"), Article IV(2); U.S. Model Income Tax Convention, June 16, 1981, Article 4(2).

[3] Consider, for example, the case of Canadian Corporation C, the majority of the shares of which are owned by Individual A. The balance of the shares of C are owned by B, a U.S. citizen. Assume A is an alien who is a Canadian citizen and resident and that A maintains his permanent and, indeed, his only home in Canada. Never having maintained a home in the United States, A has not previously been considered a resident of the United States under U.S. internal law. Assume, however, that A is present in the United States for 183 days in 1984 and therefore will be regarded as a resident alien because of the "substantial presence" test of proposed section 7701(b)(2). Notwithstanding this, A will be regarded as a resident of Canada for purposes of the pending treaty. As a result, notwithstanding that Corporation C will be regarded as a controlled foreign corporation, A will not be required to include as income subject to U.S. income tax any portion of the Subpart F income of C (see, for example, the pending treaty, Article XXII), but B will be required to do so. As a

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Classification as a resident may also affect whether the individual is exempt from tax on the receipt of bank interest[4] or whether interest paid by the individual to a foreign person is subject to U.S. tax.[5] In addition, certain of the taxes imposed by the Code may not be covered by a particular treaty—for example, the tax on transfers of appreciated property to non-U.S. entities may not be covered.

## THE PROPOSED STATUTORY DEFINITION OF RESIDENT ALIEN

Contrary to existing law, the new statutory definition will determine residence on the basis of a calendar year,[6] and an alien will be either resident or nonresident for his entire calendar year. Thus an alien could be taxable on income received before his first arrival in the United States if the income was received in the calendar year for which he was regarded as a resident. Similarly, an individual who departs from the United States during a calendar year may be taxable on income received thereafter during the year if he is regarded as a resident for that year.

### The Four Categories of Aliens Who May Be Classified as Resident

Under the proposed new statutory definition, four categories of aliens would be regarded as residents:

1) *Green card*—an alien who is a lawful permanent resident of the United States (that is, he has a green card) *at any time during the calendar year.* This rule will apply regardless of whether the individual is present in the United States during the year or regardless of any other factor.[7]

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[3]Continued . . .
second illustration, a foreign corporation owned entirely by nonresident aliens is, with one exception, excluded from being considered a personal holding company (see Code section 542(c)(7)). If Individual A in the first illustration owned 25 per cent of the stock in such a foreign corporation, the corporation could suffer the personal holding tax to the detriment of A's co-stockholders who are not "residents" even though they gain no U.S. tax reduction from utilization of the corporation for U.S. investments.

[4]A nonresident alien generally is not subject to U.S. federal income tax on interest on bank deposits because, under a special statutory provision (Code section 861(c)), such income of a nonresident alien is treated as income from non-U.S. sources with respect to which a nonresident alien is not subject to U.S. federal income tax. This special exemption does not apply to resident aliens. Moreover, many U.S. treaties, including the pending treaty, do not contain any comparable exemption. Thus, even if an alien were treated under the pending treaty as being resident only in Canada, classification of this alien as a resident of the United States under U.S. internal law would raise his U.S. tax rate on the interest from zero to the 15 per cent withholding rate provided in the treaty.

[5]Foreign persons are subject to tax on interest from U.S. "sources." The rule for determining the "source" of interest differs depending on whether the payer is a "resident" of the United States.

[6]Proposed section 7701(b)(1)(A). One exception is the case of an alien who has previously established a fiscal year as his taxable year. In this case, the alien will be treated as a resident for the portion of his fiscal year that coincides with the calendar year for which he is regarded as a resident; proposed section 7701(b)(8)(B).

[7]Proposed section 7701(b)(1)(A)(i). Previously, the United States has never maintained that resident status for immigration purposes alone is determinative of the issue of resi-
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2) *Pending application for immigrant visa*—an alien who has an application pending for an immigrant visa, if he is present in the United States for as much as 60 days during the calendar year (whether before or after the date the application is filed and whether or not the application is subsequently granted). Both this rule and the preceding rule apply whether or not the individual has a home available to him in the United States or otherwise has any substantial contacts in the United States.[8]

3) *Presence for 183 days during year*—except in the case of an "exempt individual" described below, an alien who is present in the United States for 183 days or more during the calendar year.[9] This rule applies regardless of the purpose of the U.S. presence during the year. Thus an individual who is not an exempt individual is to be regarded as a resident for a calendar year if he is present in the United States for an aggregate of 183 days or more during the year even if he maintains his sole "tax home" elsewhere and no home in the United States, if he is present in the United States solely for the purpose of completing a project of relatively short duration that in fact is completed during one calendar year or is present for the purpose of receiving medical attention, or, literally, even if he is present on an involuntary basis.[10]

4) *Cumulative presence test*—except in the case of an exempt individual, an alien who is present in the United States during the current year and the two preceding years for an aggregate of 183 days.[11] For this purpose, the number of days of U.S. presence for the first preceding year is multiplied by a factor of two-thirds, and the number of days of U.S. presence for the second preceding year is multiplied by a factor of one-third. This rule does not apply if the individual comes within the "tax home" exception described below.

Because of the aggregation of days of U.S. presence over a three-year period, it is possible for an individual to meet the cumulative presence test even if he is not present at all during the current year—if, for example, he was present in the United States for 183 days during the first preceding year and 183 days during the second preceding year. While it appears more logical to apply this rule only to cases where an individual is present in the United States for some minimum period of time during the taxable year, no such limitation is included in the

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[7]Continued...
dence. See Rev. Ruls. 76-82, 1976-1 CB 192; 72-140, 1972-1 CB 211; and 72-297, 1972-1 CB 212 ("Admission to the United States for permanent residence pursuant to the Immigration and Nationality Act does not *per se* establish residence for Federal income tax purposes.") See also *William E. Adams*, 46 TC 352 (1966), acq., 1967-2 CB 1 (holding a Canadian individual to be a nonresident alien notwithstanding that he applied for and obtained an immigrant visa).

[8]Proposed section 7701(b)(1)(A)(ii).

[9]Proposed sections 7701(b)(1)(A)(iii) and 7701(b)(2).

[10]In *Stemkowski v. Commissioner*, 76 TC 252 (1981), reversed and remanded in part, 690 F. 2d 40 [50 AFTR 2d 5740] (2d Cir. 1982), the petitioner, a Canadian hockey player, was actually present in the United States for more than 200 days. Notwithstanding this presence, no assertion was made that the petitioner was a resident of the United States. For background to this case, see J. Ross Macdonald, "Stemkowski and Hanna v. Commissioner: The Canadian Hockey Players' Lament Turns to a (Partial) Paean," in this feature (May-June 1983), 31 *Canadian Tax Journal* 475-77.

[11] See supra footnote 9.

statute. Similarly, an individual may meet the cumulative presence test for a year if he is present for as little as 93 days in the current year and 90 days in each of the first and second preceding years. In this case, the individual's cumulative U.S. presence will total 183 days (that is, 93 + 60 + 30). Why such a low threshold of U.S. presence was selected is unclear. Many aliens vacation in the United States (in Florida, for example) for more than three months each year. Although some of these individuals may fall under the tax home exception discussed below, others may not. It is not clear whether the draftsmen intended to tax these aliens on their worldwide income, but the statute seems to have that effect. Moreover, notwithstanding that the new provision is to be effective for taxable years beginning after December 31, 1983, it appears that U.S. presence during 1983 and 1982 will count in determining the cumulative presence test for 1984.

An alien who meets the cumulative presence test but who is not present in the United States for 183 days during the current year will not be regarded as a resident alien if he can establish that, *for the current year,* he has a "tax home" in a foreign country *and* that he has a closer connection to that foreign country than he has to the United States.[12] This may have to be established on a form to be prescribed by regulations.[13]

• *Tax home during part of year.* As a preliminary point, it is unclear as to when, during the current calendar year, the alien must have had his tax home in a foreign country. For example, this issue may arise if an alien relinquishes his foreign tax home on July 15 of a year in order to take up residence in the United States. Must he be able to establish that he had a tax home elsewhere for the entire calendar year, or for only a part of the year? It appears that the foreign tax home literally must be in existence for the entire year. Whether this is intended is far from clear, however.

• *Tax home defined.* The term "tax home" is assigned the meaning given to that term under Code section 911(d)(3).[14] Under that provision, an individual generally has his tax home at his principal place of business. If an individual has no principal place of business, his tax home generally is the place where he has his regular place of abode.[15]

Section 911(d)(3) further provides that *an individual cannot be considered to have his tax home in a foreign country for any period for which his "abode" is within the United States.* This limitation was inserted in section 911 to bar an individual resident in the United States near the Canadian border from claiming the benefits of section 911 for income earned at a regular place of employment

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[12] Proposed section 7701(b)(2)(B).

[13] Proposed section 7701(b)(7).

[14] A U.S. citizen or resident qualifying for the benefits of section 911 may exclude from income subject to U.S. federal income tax a limited amount of earned income from foreign sources. To qualify for the benefit of section 911, an individual must establish, among other things, that his tax home is in a foreign country.

[15] See Proposed Reg. section 1.911-2(b).

in Canada to which he regularly commutes from his home in the United States.[16] The application of this rule to the definition of "resident alien" seems unduly harsh and perhaps is an oversight. Nevertheless, unless this is clarified, an alien having an abode in the United States at any time during the year will be disqualified from the tax home exception.

• *Abode.* The term "abode" is not defined in the statute or in the regulations that interpret section 911(d)(3), and there is considerable uncertainty regarding the meaning of the term. It appears to include any place of accommodation used by the alien on some extended basis. Thus the use of an apartment for a continuous period of several months during the year may constitute an abode, but the use of an apartment for only a two-week vacation period may not. Nor does it appear that any great comfort could be obtained were the alien to use someone else's apartment for the requisite duration. There does not appear to be any requirement that the place be used exclusively by the taxpayer or that the taxpayer own or lease the space. Given the uncertainty regarding this issue, aliens intending to rely on the tax home exception for 1984 may have to consider relinquishing any place of accommodation in the United States before the end of calendar year 1983.

• *Closer connection.* Establishing that an individual's tax home is in a foreign country is insufficient, of itself, to come within the exception from the application of the cumulative presence test. The individual also must establish that he has "closer contacts" with the foreign country in which he has a tax home than he has with the United States.[17] It is unclear whether the significant contacts are those of a business or personal nature. If the former, given that the principal place of business will ordinarily be the tax home, the closer contact test may add little. If the latter, however, new difficulties may arise. For example, an alien who regularly resides in Foreign Country A but who has his principal place of business in Foreign Country B may find it difficult to establish that his personal contacts are more closely associated with Country B than with the United States.

**Exempt Individuals**

An alien who does not have (and has not applied for) a green card will not be regarded as a resident alien—even if he otherwise meets the 183-day presence test or cumulative presence test—if he qualifies as an exempt individual for the portion of the year he is present in the United States.[18] An alien will not be considered an exempt individual if all of the facts and circumstances indicate that he intends to reside permanently in the United States. With certain exceptions, the term "exempt individual" means foreign-government-related individuals, teachers or trainees, and students.

• *Foreign-government-related individuals.* In general, a foreign-government-related individual is one who has been temporarily admitted to the United States because of his diplomatic status or because he is a full-time employee of an inter-

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[16] H. Rept. no. 1463, 95th Cong., 2d Sess., at 10 (1978).

[17] Proposed section 7701(b)(2)(B)(ii).

[18] Proposed section 7701(b)(2)(C).

national organization or a member of the immediate family of the above-described persons.

• *Teachers, trainees, and students.* Individuals who fit within this category must be admitted under the appropriate provision of the Immigration and Nationality Act relating to their special status and must comply substantially with the conditions for admission. Some special limitations apply:

•• Teachers or trainees will not be exempt individuals for the current year if, for any two calendar years during the preceding six calendar years, the person was exempt as a teacher, trainee, or student.

•• A student will not be an exempt individual for any calendar year after the fifth calendar year for which he is exempt as a student unless he has established that he had no intent to reside permanently in the United States. Why this last condition is included is unclear. If the facts and circumstances indicate that the individual had an intent to reside permanently in the United States, he could not qualify as an exempt individual in the first place. Apparently, an added presumption is intended (over and above the normal presumption of the correctness of the Commissioner's finding).

It appears that in the case of teachers or trainees, as well as in the case of students, the years taken into account start with the first year for which the new provisions will be in effect—that is, 1984. Whether this was intended, however, is not certain.

### "Presence" and "Commuters"

Ordinarily, an alien will be regarded as present in the United States on any day in which he is present in the United States for any portion of the day.[19] There is, however, one exception to this rule. An individual who regularly commutes to the United States from a place of residence in Canada or Mexico will not be regarded as present in the United States on any day during which he so commutes.[20] Presumably, "commutation" means a trip that is completed within one day.

## EFFECTIVE DATE

Should the Act be enacted, it will be effective for taxable years beginning after December 31, 1983.[21] As noted above, however, days of U.S. presence in 1983 and 1982 will apply in determining whether an individual has met the cumulative presence test for 1984.

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Although it is by no means clear that the new statutory definition of "resident alien" will find its way through the legislative process in precisely its current form, aliens will be well advised to start reconsidering their circumstances in the light of the possible enactment of the new definition.

An Addendum to this article appears on the following pages.

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[19] Proposed section 7701(b)(6)(A).

[20] Proposed section 7701(b)(6)(B).

[21] Section 501(b), HR 3475.

## ADDENDUM

On October 20, 1983 and subsequent to the preparation of this article, the House Ways and Means Committee approved H.R. 4170, the "Tax Reform Act of 1983." Section 451 of that bill replaces the definition of resident alien previously contained in section 501 of the Tax Law Simplification and Improvement Act of 1983 (which will be referred to as the "old version") with a new definition that generally follows the old version with certain important modifications. Although there still may be additional modifications as the new bill continues through the legislative process, the significant changes from the old version proposed by the new bill are summarized briefly below.

### Pending Application for Immigrant Visa

Under the old version, an alien who has an application pending for an immigrant visa and who is present in the United States for an aggregate of 60 days during the year would have been regarded as a resident. The new bill contains no such rule. Rather, the new bill provides that an alien who has an application pending for lawful permanent residency will not be able to avail himself of the "tax home" exception to the "cumulative presence test." Thus, if such an alien was present in the United States for a sufficient period to meet the cumulative presence test, he would be regarded as a resident regardless of any other fact or circumstance.

### Mitigation of Entire Year Concept

Under the old version, an alien generally would have been regarded as a resident or nonresident for the entire calendar year. The new bill would provide important exceptions for aliens who first become residents during a year and for aliens who abandon residency during a year.

1) *First acquisition of residence.* Under the new bill, if an alien was not a resident in the United States at any time during the preceding calendar year, but is regarded as a resident in the current year, he is regarded as resident in the United States

a) only from the first day he is present in the United States in the current year if he is regarded as a resident of the United States for the year under either the 183-day presence rule or the cumulative presence test, or

b) if he is not regarded as a resident by virtue of either of the two rules noted in (a) but is regarded as a resident because he has acquired a green card, only from the first day he was present in the United States while he was a lawful permanent resident.

For purposes of the two rules noted above, any continuous period for which it can be shown that the alien had a closer connection to a foreign country than he had to the United States will be disregarded. This is subject to the limitation that the period to be disregarded cannot include more than 10 days of presence in the United States.

2) *Abandonment of residence.* Under the new bill, an alien who relinquishes his U.S. residence during a year would not be regarded as a resident of the United States after the last day during the year in which he was present in the United States if two conditions are met: (a) he cannot be a resident of the

United States at any time during the next calendar year, and (b) he must show that he has a closer connection to a foreign country than he has to the United States during the balance of the year in which he abandoned U.S. residence. The *de minimis* 10-day rule noted above also applies for purposes of determining the last day the alien would be regarded as a resident in the current year.

**Presence for 183 Days During Year**

Except in the case of an exempt individual, the old version provided that an alien who is present in the United States for 183 days during a year is to be regarded as a resident for the entire year without any exceptions. The new bill, in addition to providing exceptions for aliens who are not resident for the preceding year or the succeeding year, does not apply this rule in the case of an alien who is unable to leave the United States because of a medical condition that arises while the alien is in the United States.[22] In any event, presence in the United States even for medical reasons would count for purposes of the cumulative presence test.

**Cumulative Presence Test**

Under the old version, an alien was regarded as a resident for a year (unless the "tax home" exception applied) if his U.S. presence for the current year and the two preceding years aggregated 183 days counting only two-thirds of the days in the first preceding year and one-third of the days in the second preceding year. Moreover, days of presence in the United States in 1982 and 1983 counted for purposes of the calculation required for 1984 and 1985. The new bill changes this in several important respects.

1) The bill counts only one-third of the days of U.S. presence in the first preceding year and only one-sixth of the days in the second preceding year. Thus, under the bill, an individual could be present in the United States for an aggregate of 121 days each year without being regarded as a resident, rather than the 92 days the old version allowed.

2) The bill would provide that the cumulative presence test does not apply for a year unless an individual was actually present in the United States for 31 days during the current year. Under the old version, an alien could have met the cumulative presence test for a year without actually being present in the United States during the current year.

3) Under the bill, days of U.S. presence in 1982 count for purposes of the 1984 calculation only if the alien was a resident of the United States under existing law as of the close of calendar years 1982 and 1983. Furthermore, presence in the United States during calendar year 1983 counts for purposes of the calculation required for 1984 and 1985 *only* if an alien were a resident of the United States under existing law as of the close of calendar year 1983. Thus an individual, who under current law was not a resident in the United States as of the close of either calendar year 1982 or 1983, may be present in the

[22] If read literally, this would appear to provide an exception to the automatic residence determination for 183 days of presence even if the alien was present in the United States for 183 days without regard to the number of days he was unable to leave because of the medical emergency. It is unlikely that this was intended.

United States for up to 182 days in 1984 without being regarded as a resident in 1984. Of course, such presence would count for the calculation that would be required for 1985 and 1986. Presence in 1984 would likely be considered for purposes of determining whether an alien was a resident for any period prior to 1984.

### Tax Home Exception

The old version provided that an alien who meets the substantial presence test (and who is not present in the United States for 183 days during the year) would not be regarded as a resident if two conditions are met: (1) he must have a "tax home" in a foreign country for the year, and (2) he must have a "closer connection" to that foreign country than he has to the United States. The old version further appeared to provide that an individual could not establish a tax home outside the United States for any period during which his "abode" was in the United States. The new bill does not bar an alien from establishing that his tax home is outside the United States merely because he also has an abode in the United States. An abode in the United States, of course, may well be considered relevant in determining where the individual's tax home is and may also be relevant for purposes of determining whether the alien's connections are closer to the United States than to the foreign country in which he has a tax home, as well as (where applicable) whether he was a resident as of the close of 1982 and 1983.

## UNITARY TAXATION: THE STATES WIN ROUND ONE

*Arnold B. Panzer*

*Several states of the United States employ the "unitary method" to determine the taxable income attributable to the state of a corporation that is a member of a related group of corporations conducting a "unitary business." Attempts by some states to apply the unitary method with respect to the U.S. subsidiaries of foreign parents have provoked vigorous protests from Canada, the United Kingdom, and other countries. In* Container Corporation of America v. Franchise Tax Board, *decided June 27, 1983, the Supreme Court of the United States upheld California's use of the unitary method to determine the taxable income of a U.S. corporation with numerous foreign subsidiaries. Though a setback to taxpayers,* Container Corporation *is not the final word on the use of the unitary method in the international sphere.*

### FORMULA APPORTIONMENT AND THE UNITARY BUSINESS

The so-called unitary method of taxation is actually an advanced form of formula apportionment. In the case of a single corporation operating in more than one state of the United States, formula apportionment determines the portion of the corporation's income attributable to a particular state for corporate income tax purposes by multiplying the corporation's total income by an in-

state "apportionment percentage." The appropriate percentage is computed for each taxpayer on the basis of one or more "factors," specified in the state's apportionment formula, that compare the taxpayer's activities in the taxing state with its total activities everywhere.

While some states have adopted apportionment formulas based on a single factor, such as the ratio of the taxpayer's in-state sales to total sales,[1] the typical apportionment formula computes the apportionment percentage as an average of three factors:

1) the ratio of the taxpayer's in-state sales to total sales from all sources,

2) the ratio of the taxpayer's in-state payroll to total payroll, and

3) the ratio of the value of the taxpayer's in-state real and tangible personal property to the value of its total real and tangible personal property wherever located.[2]

The following illustrates the computation of the apportionment percentage for a multistate enterprise doing business in State A, which uses the standard three-factor formula:

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| Sales factor: | $\frac{\text{State A sales}}{\text{Total sales}}$ | = | 20% |
| Payroll factor: | $\frac{\text{State A payroll}}{\text{Total payroll}}$ | = | 10% |
| Property factor: | $\frac{\text{State A property}}{\text{Total property}}$ | = | 30% |
| Apportionment percentage | $= \frac{20\% + 10\% + 30\%}{3}$ | = | 20% |

Some states, such as New York and Florida, doubleweight the sales factor: the sales factor is added twice and the total of the factors is divided by four rather than three to yield the apportionment percentage. Numerous variations also exist in the precise mechanics used to compute each of the three apportionment factors.

Formula apportionment has played a central role in the history of state and local taxation in the United States, where the early development of interstate commerce made the taxation of multistate business corporations a fundamental problem in the development of state systems of income taxation. The concept that income from interstate commerce was immune to state taxation under

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[1] The Court recently upheld Iowa's use of such an apportionment formula in *Moorman Manufacturing Company v. Bair*, 437 U.S. 267 (1978).

[2] In computing the sales factor, receipts from the sale of tangible personal property are generally allocated to the state in which the property is delivered to the customer, although a number of state allocation formulas provide for an alternative allocation of receipts when the taxpayer is not subject to tax in the state of destination. See, for example, California Revenue and Taxation Code section 25136. Receipts from the performance of services are allocated to the state in which the services are performed.

the U.S. Constitution eventually gave way to the view that interstate commerce must pay its "fair share" and that the state taxation of interstate business is permissible so long as the tax is "fairly apportioned," nondiscriminatory, and reasonably related to the activities of the taxpayer in the taxing state.[3] The use of "separate" or "geographical" accounting techniques as the preferred method for determining the income of a multijurisdictional business attributable to a particular state was eventually rejected by most states in favour of formula apportionment.[4] At an early date, the U.S. Supreme Court sanctioned the use of this method in preference to separate accounting as to both multistate and multinational corporations.[5]

Formula apportionment is inextricably connected with the elusive concept of the "unitary business." Indeed, a unitary business may be defined as a multijurisdictional enterprise whose nature is such that the portion of its total income allocable to the taxing state cannot be satisfactorily determined by separate accounting techniques. A single corporation may conduct two or more separate unitary businesses.[6] By the same token, a single unitary business may be conducted by a number of corporations related by common ownership.

## THE DEVELOPMENT OF THE UNITARY METHOD

A common problem in both state and international taxation stems from the distortions in income that may arise from transactions between members of an affiliated group of corporations that occur at other than arm's length prices. By chance or design, an undue percentage of the total profits of the group may be realized by those members of the group who are not subject to tax in those jurisdictions imposing relatively heavy taxes. Jurisdictions that rely on separate accounting techniques attempt to meet this problem by requiring that intercorporate transactions reflect arm's length prices, and they authorize their tax administrators to adjust the income of taxpayers to reflect the taxable income that would have been realized if intergroup transactions had occurred at arm's

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[3]Under the "commerce clause" of the U.S. Constitution (Article I, section 8, clause 3), Congress is given authority to regulate commerce among the states and with foreign nations. It was at one time believed that this provision precluded the states from imposing any tax on interstate business. The somewhat contorted evolution of the Supreme Court's concept of the commerce clause and its impact on state taxation is detailed in Paul J. Hartman, *Federal Limitations on State and Local Taxation* (Rochester, N.Y.: Lawyers Co-operative Publishing, 1981), 52-130, and Jerome R. Hellerstein, *State Taxation*, Vol. 1 (Boston: Warren, Gorham & Lamont, 1983), 99-126. Cases illustrating the Court's most recent approach to the commerce clause include *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977); *Department of Revenue of Washington v. Association of Washington Stevedoring Cos.*, 435 U.S. 734 (1978); and *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

[4]The decline of "separate accounting" as a method for allocating income for state tax purposes is discussed in Jerome R. Hellerstein and Walter Hellerstein, *State and Local Taxation*, 4th ed. (St. Paul, Minn.: West Publishing Co., 1978), 432-38.

[5]See *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Bass, Ratcliffe & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924).

[6]The model regulations of the Multistate Tax Commission provide that where a taxpayer conducts two or more separate businesses, the income of each business must be separately apportioned within and without the taxing state.

length prices. At the U.S. federal income tax level, this approach is embodied in section 482 of the Internal Revenue Code and in income tax treaties.

Similar powers generally have been granted to state tax administrators, but the powers are not frequently used since the states for the most part do not have the resources to enforce arm's length accounting standards in more than a handful of instances. Instead, the response of a growing number of states has been the adoption of the unitary method.

The unitary method of combined formula apportionment seeks to solve the problem of intergroup transactions by treating the affiliated group as if it were a single corporation of which the member that was subject to tax was merely a branch. The income of the taxpayer attributable to the taxing state is determined by multiplying the group's combined income by an apportionment percentage that is computed by dividing the taxpayer's in-state receipts, payroll, and property by the combined receipts, payroll, and property of the entire group. The typical effect of the unitary method is to increase the taxpayer's total net income while decreasing its apportionment percentage. Depending on the circumstances, the net income apportioned to the taxing state under the unitary method may be greater or less than that which would result under a separate apportionment.

In theory, the unitary method not only solves the problem of intercorporate transactions but also takes account of the more subtle distortions of income that may arise where a single business is conducted in a multicorporate form. Consistent with the basic principles of formula apportionment, the unitary method may be applied only to affiliated corporations that are conducting a single unitary business with the taxpayer.

The unitary method was pioneered by California and Oregon and is now practised in at least 12 states.[7] The state that most recently introduced combined formula apportionment is Florida, which adopted the method a few weeks after the U.S. Supreme Court decision in *Container Corporation.*

While uniformly unpopular with business, the unitary method's most vocal opposition has arisen from its application in the international sphere, where it has been applied to both domestic parents of foreign subsidiaries and domestic subsidiaries of foreign parents. In *Container Corporation,*[8] the unitary method passed its first test before the Supreme Court in a case involving a domestic corporation with foreign subsidiaries.

## THE CONTAINER CORPORATION DECISION

The Container Corporation of America, a Delaware corporation, is a vertically integrated manufacturer of paperboard packaging that has 20 foreign subsidiaries

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[7]Alaska, California, Colorado, Florida, Idaho, Massachusetts, Montana, Nebraska, North Dakota, Oregon, Utah, and the District of Columbia; Federation of Tax Administrators, Research Memorandum 547, December 1982. Illinois also recently adopted the unitary method, but the state legislature limited its application to exclude corporations that conduct 80 per cent or more of their business activities outside the United States. Several other states, including New York, limit use of the unitary method to U.S. taxpayers and affiliates.

[8]51 U.S.LW 4987.

organized in four Latin American and four European countries. Each subsidiary is engaged in essentially the same business as its parent and each is subject to tax on its separate income by its country of organization. For reasons that will be discussed more fully below, the California Franchise Tax Board determined that Container Corporation was engaged in a unitary business with its subsidiaries and recomputed its income using the unitary method; Container Corporation's income and allocation factors were combined with those of its foreign subsidiaries, none of which were subject to tax in California. The Franchise Tax Board's actions were affirmed by the California appellate courts.

On appeal to the Supreme Court, Container Corporation's first argument against California's use of the unitary method was that formula apportionment in the international sphere inevitably resulted in multiple taxation since the formula tends to attribute a higher proportion of income to jurisdictions such as the United States where wage levels, property values, and sales prices are higher. The three-factor formula presupposes that wage levels, property values, and sales prices are constant in each jurisdiction in which the unitary business is conducted, whereas wage rates, sales prices, and property values were in fact significantly lower in the foreign countries in which Container Corporation's subsidiaries operated. As a consequence, the three-factor formula produced an inherently distorted result, allocating proportionately more income to California where wage levels, property values, and sales prices were higher. This argument is difficult to fault and goes right to the heart of formula apportionment.

The Court did not, and probably could not, meet this argument head on. Instead, it focussed on the shortcomings of the alternative to formula apportionment—separate accounting. In the Court's view, separate accounting is at least as imperfect as formula apportionment but, unlike formula apportionment, separate accounting fails to account adequately for contributions to income resulting from functional integration, centralization of management, and economies of scale. The Court ruled that Container Corporation had failed to prove that the "margin of error" inherent in California's three-factor formula was any greater than the margin of error inherent in the separate accounting that the taxpayer offered as evidence. Moreover, the error in the allocation of taxable income, which Container Corporation claimed to have resulted from the state's use of the unitary method, was only about 14 per cent, a figure that the Court felt was "certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business."

It appears highly doubtful, in the light of *Container Corporation,* that the results arrived at by the unitary method can ever be successfully impeached by the use of separate accounting techniques.

Container Corporation's second argument against the unitary method was based on a 1979 decision of the Supreme Court in *Japan Line v. County of Los Angeles.*[9] In that case, the Court held that California could not impose even a fairly apportioned property tax on the value of cargo containers that were owned by a Japanese corporation, used exclusively in foreign commerce, and subjected to an unapportioned property tax in Japan. In arriving at this con-

[9]441 U.S. 434 (1979).

clusion, the Court stated that when a state seeks to tax the "instrumentalities of foreign commerce," two additional considerations come into play that do not arise in the taxation of domestic corporations. The first consideration is the "enhanced risk of multiple taxation" that arises in an international context. Since Japan was already imposing an unapportioned tax on the full value of the cargo containers and the Court had no power to alter that situation, any additional tax by California, even though nondiscriminatory and fairly apportioned, resulted in multiple taxation.

The second consideration is that a state tax in the area of foreign commerce might have undesirable foreign policy implications and "impair federal uniformity in an area in which federal uniformity is essential." A novel state tax could create "an asymmetry in the international tax structure" and lead disadvantaged foreign nations to levy retaliatory taxes on all American-owned instrumentalities in their jurisdictions. Because of these foreign policy implications, the nation must be able to speak with "one voice" in matters affecting international trade.

Following the first prong of *Japan Line,* Container Corporation argued that California's use of combined formula apportionment represented a major departure from both federal taxing policies and "accepted international practice," which generally favours the separate accounting/arm's length approach. In its view, California's departure from the international norm virtually assured the multiple taxation of foreign commerce. In Container Corporation's case, the taxpayer's subsidiaries were being doubly taxed—once by their home country on their separate incomes and again by California as part of the apportioned income of Container Corporation.

The Court responded to this by noting that California's use of the arm's length method would not necessarily have prevented the alleged double taxation from occurring. Differences in the rules used to implement the arm's length method, as well as differences in their application by the various taxing authorities, made the total elimination of double taxation impossible. Since some degree of multiple taxation was inevitable under either method, the U.S. Constitution did not require that the arm's length approach be imposed on California simply because it was the more common of the two methods.[10]

Container Corporation's last and most troublesome argument was based on the second prong of the *Japan Line* doctrine—the rule that a state tax on foreign commerce must not impair federal uniformity or "prevent the Nation from speaking with one voice" in the area of international trade. The Court agreed that a state tax at variance with federal policy would violate the "one voice" standard if the tax either "implicated foreign policy issues" or violated a "clear federal directive." It did not agree, however, that California's application of the unitary method to Container Corporation ran afoul of either test.

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[10] Strangely enough, the Court appeared to accept the taxpayer's contention that an overlap of state and foreign taxes was an instance of "double taxation." Yet it could not be seriously contended that the *Japan Lines* doctrine would preclude California from imposing any tax on a corporation doing business within the state that was organized under the laws of a country like Canada, which taxes its corporations on their worldwide income.

The Court first concluded that, although the federal government itself utilized "geographical" accounting and the arm's length method in taxing foreign corporations, there was no clear federal directive prohibiting the use of alternative methods by the states. The Court noted that, although the United States is a party to many international treaties that arguably require the United States to observe some form of geographical accounting method in taxing the domestic income of its residents and corporations, none of these treaties presently applies to subnational units such as the states. In the one instance in which a proposed treaty did contain an explicit prohibition on the states' use of the unitary method (the U.S.-U.K. tax convention), the U.S. Senate attached a reservation declining its consent to the provision. The Court also noted that, unlike the situation in *Japan Line,* the U.S. Executive Branch had not filed a brief with the Court objecting to the state tax. These factors, and the long-standing failure of Congress to enact any legislation bearing on the subject, made it clear to the Court that the California taxing scheme was not prohibited by any explicit federal directive.

The question of whether California's use of the unitary method had undesirable foreign policy implications proved a bit thornier. The Court observed that the principal risk to be evaluated was "the threat that [the unitary method of taxation] might pose of offending our foreign trading partners and leading them to retaliate against the nation as a whole." While admitting that it had little competence in evaluating risks of this nature, the Court noted three considerations that it felt weighed strongly against the conclusion that California's use of combined apportionment might "justifiably lead to significant foreign retaliation."

The Court's first consideration was that the California scheme did not create "an automatic asymmetry" in international taxation, as did California's apportioned property tax on the foreign-owned cargo containers in *Japan Line.* The Court was presumably referring to its earlier conclusion that the unitary method did not inevitably lead to multiple taxation, or at least did not pose a significantly greater risk of double taxation than would exist if California used some sort of arm's length method.

The Court's second observation was that the taxpayer was, after all, a domestic corporation and not a foreign entity, as was the owner of the cargo containers in *Japan Line.* While California did take into account the income of the taxpayer's foreign subsidiaries in determining the taxpayer's income attributable to California, the "legal incidence" of the tax fell exclusively on the U.S. parent corporation, which appeared to be owned principally by U.S. interests. In a footnote, the Court added the following caveat, the significance of which will likely loom large in the future:

> We recognize that the fact that the legal incidence of the tax falls on a corporation whose formal corporate domicile is domestic might be less significant in the case of a domestic corporation that was owned by foreign interests. We need not decide here whether such a case would require us to alter our analysis.[11]

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[11] Supra footnote 8, at footnote 32.

The Court's third observation was that, even if foreign countries did have a legitimate interest in reducing the tax burden on domestic corporations, the actual tax burden on such corporations was "more a function of California's tax rate than its allocation method." In the Court's view, a foreign country should not be significantly more offended by what it considers an "unorthodox" method of taxation than it would be if California simply raised its general tax rate to achieve the same economic result.

Three of the eight justices participating in the case dissented in an opinion written by Justice Powell. The dissenting justices agreed with the taxpayer's characterization of the unitary method as an extreme departure from "accepted international practice" whose use virtually assured double taxation in the international sphere. In their view, the unitary method fails the tests set forth in *Japan Line* and should never be applied so as to include foreign corporations in the unitary group, regardless of whether the taxpayer is a parent or subsidiary.

*Container Corporation* leaves little doubt as to the validity of the unitary method as applied to domestic taxpayers that are parents of foreign subsidiaries. By virtue of the way in which the majority resolved the *Japan Line* issue, however, the validity of the unitary method as applied to taxpayers that are either foreign corporations or domestic corporations controlled by foreign interests remains an open question. Since there currently is no case pending before the Supreme Court in which this question is presented, the question is likely to remain open for some time.

## THE UNITARY BUSINESS ISSUE

Space limitations do not permit a full analysis of the Supreme Court's handling of the unitary business issue. Two points must be mentioned, however. First, the Court's present concept of what a unitary business is seems to depart from the views it expressed in its last two recent cases on the subject–*ASARCO* and *Woolworth*.[12] These two opinions indicated that "actual managerial control" coupled with "functional integration" or "mutual operational interdependence" were necessary elements to the existence of a unitary business. Although the same terms reappear in *Container Corporation,* they now seem to be largely drained of content. The grounds on which the Court distinguished *Container Corporation* from *Woolworth* and *ASARCO* suggest that the degree of managerial control, functional integration, and operational interdependence needed to establish the existence of a unitary business need not be all that great.[13] The factors on which the Court relied in *Container Corporation* were as follows:

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[12] *ASARCO, Inc. v. Idaho State Tax Commission,* 102 S.Ct. 3103 (1982), and *F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico,* 102 S.Ct. 3128 (1982). Unlike *Container Corporation,* these cases did not involve combined formula apportionment, but instead concerned the question of whether a state could properly require the inclusion of dividends received from other corporations in the payee's tax base subject to formula apportionment. The Supreme Court held in *ASARCO* that, in the absence of some other connection between payer and the taxing state, such dividends could be included in the payee's apportionable income only if the payee and the payer were engaged in a unitary business.

[13] Another source of disappointment was the Court's rejection of Container Corporation's suggestion that the Court adopt a "bright line" standard whereunder a manufacturing or mercantile business will not be deemed unitary unless there is a "substantial flow of goods" among its members.

• Approximately half of the subsidiaries' long-term debt was held directly or guaranteed by Container Corporation.

• Container Corporation charged one senior vice-president and four other officers with the task of overseeing the operations of the subsidiaries. These officers established general standards of "professionalism, profitability and ethical practices" and dealt with major problems and long-term decisions. Local decisions were subject to review by Container Corporation, although problems generally were worked out by "consensus" rather than outright domination.

• Container Corporation furnished technical advice and consultation to a number of its subsidiaries regarding manufacturing techniques, engineering, design, architecture, insurance, and cost accounting, either through formal technical service agreements or by informal arrangement.

• Container Corporation assisted its subsidiaries in obtaining new and used equipment either by selling them used equipment of its own or by employing its own purchasing department to act as agent for the subsidiaries.

• Container Corporation assisted its subsidiaries in filling personnel needs that could not be filled locally.

The Court stated that it was unnecessary to decide whether any of these factors, standing alone, would be sufficient to establish the existence of a unitary business.

The second and equally important aspect of the *Container Corporation* decision is its emphatic announcement that the Court will now be reviewing the determinations of state courts on unitary business questions under a relatively narrow legal standard. The scope of its inquiry in unitary business cases henceforth will be limited to a determination of whether the state court applied the correct legal standards to the case and, if so, whether its determination was "within the realm of permissible judgment." This language is no doubt a disappointment to many commentators who thought they had observed in *ASARCO* and *Woolworth* a new willingness on the part of the Court to search the record and come to an independent conclusion regarding the existence of a unitary business.

The efforts of foreign corporations with U.S. subsidiaries to have unitary tax issues resolved in the federal courts have thus far been unavailing. Federal law prohibits federal courts from enjoining state tax proceedings so long as the state courts provide a "plain, speedy and effective" remedy for the resolution of such disputes.[14] Foreign parents whose income has been included in determining the apportionable income of their subsidiaries have attempted to avoid this procedural obstacle by bringing suit in their own right in federal court and arguing that, since they are not themselves the taxpayer, they do not have a plain, speedy, or effective remedy in the state courts. In a recent decision, the Federal Court of Appeals for the Ninth Circuit dismissed such an action by Shell Petroleum, reasoning that, since Shell was not the taxpayer in the state tax proceeding, it lacked the requisite standing to sue for relief.[15]

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[14] 28 U.S. Code section 1341.

[15] *Shell Petroleum, N.V. v. Graves*, 709 F.2d 593 (9th Cir. 1983).

## PROSPECTS FOR THE FUTURE

The Supreme Court's decision in *Container Corporation* has touched off a storr of protest from foreign officials, including those of the governments of Canad the United Kingdom, Japan, and the Netherlands.[16] Their efforts are principall aimed at convincing the Reagan administration to support legislation now pen ing before the Congress that would prohibit the states from including a foreig corporation in a unitary business group.

In response, President Reagan requested his Cabinet Council on Economi Affairs to study the unitary question and issue a recommendation. In earl September 1983, the Cabinet Council announced its support for a legislativ solution to limit the use of the unitary method to U.S. corporations. Presider Reagan, however, declined to accept this recommendation and instead propose the formation of a "task force" to study the issue further. The proposed con mittee would reportedly include representatives from the states, the feder government, multinational firms, and major U.S. trading partners, and would b asked to develop "a single package of recommendations on which all coul agree."[17]

It also was announced that the Reagan administration would not file a bri supporting Container Corporation's bid to obtain a rehearing before the U. Supreme Court. This move was generally seen as a victory for the states.

There is some speculation that the administration will propose a solutic whereby application of the unitary method will continue to be permitted as t foreign subsidiaries of a U.S. parent corporation (as in *Container Corporation* but not as to the foreign parent of a U.S. subsidiary. Such a position should least satisfy international opponents of the unitary method whose protes have focussed mainly on the application of the unitary method to the foreig parents of U.S. subsidiaries.

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[16] A letter expressing Canadian concerns was sent by Finance Minister Marc Lalonde U.S. Treasury Secretary Donald T. Regan on August 8, 1983. This action followed a simil protest by the British Chancellor of the Exchequer, Nigel Lawson.

[17] *Daily Tax Report*, No. 185 (New York: Bureau of National Affairs, September 2 1983) at G-4 to G-5.

# CORPORATE CONTINUANCES: CAN THEY BE USED TO AVOID U.S. TAXATION ON TRANSFERS OF ASSETS BETWEEN U.S. AND CANADIAN CORPORATIONS?

*Stanley Weiss*

*The statutes of some states of the United States and of Canada and some of its provinces permit a corporation organized in one of such jurisdictions and migrating to another jurisdiction to be treated as if it had been incorporated in the other jurisdiction. While a recent pronouncement of the U.S. Internal Revenue Service and the U.S. Technical Explanation of the pending Canada-U.S. income tax convention seek to deal with some*

*tax consequences of such corporate continuances, a comprehensive approach has not yet been developed.*

The U.S. income tax implications of corporate continuance and discontinuance statutes have been slow in percolating to the surface but attention was drawn to them recently by the release to the public of GCM 38989 (the "GCM").[1] These statutes permit a corporation to "migrate" from one jurisdiction to another, ostensibly changing its place of incorporation while remaining the same corporate entity.[2] This migration may occur across national borders, thus raising the possibility, for example, of converting a U.S. corporation into a Canadian or other foreign entity and vice versa without the necessity of complying with Code section 367. Although the GCM was concerned primarily with the application of the capital gains exemption of the existing Canada-U.S. income tax treaty to so-called collapsible corporations,[3] it did touch on the question whether the continued company was the same corporate body or whether continuance involved the constructive transfer of assets to a new entity, which would bring Code section 367 into play.

Corporate continuance statutes have been adopted not only in Canada and some of its provinces but also in a number of states in the United States.[4] In general, these statutes provide that, on the issuance of a certificate of registration following the filing of articles of continuance, the corporation is to be treated as if it had been incorporated in the jurisdiction in which it is continued. A few of the states in the United States also provide, like Canada, for the discontinuance of corporations migrating to other jurisdictions.[5] In the United States at least, even the corporate law consequences of continuances

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[1]GCM 38989, dated January 14, 1983, relating to LTR 8320031, dated February 15, 1983. As indicated in various affidavits and statements provided to the Court by the IRS in *Taxation with Representation Fund v. IRS*, 47 AFTR 2d 81-1026 (D.C. Cir. 1981), and cited therein at 81-1027–81-1028, a GCM is a legal memorandum from the Office of Chief Counsel of the IRS prepared in response to a request for legal advice from the Assistant Commissioner (Technical), which request is made in connection with a proposed private letter ruling, technical advice memorandum, or revenue ruling. GCMs are prepared in connection with only about two per cent of all letter rulings, technical advice memoranda, and revenue rulings; involve the research of appropriate statutes, regulations, revenue rulings, case law, previous GCMs, and briefs prepared by the Office of Chief Counsel; and set forth a lengthy legal analysis of the substantive issues and the conclusions reached. GCMs, however, as internal memoranda of the IRS, presumably may not be cited as precedent by taxpayers.

[2]Miss. Code Ann. section 79-1-19 (1972 and Supp. 1982); Neb. Rev. Stat. section 21-20, 122 (1977); 15 Pa. Cons. Stat. Ann. section 1909 (1980 and Supp. 1983); Utah Code Ann. section 16-10-51.5 (1977 and Supp. 1981); Wyo. Stat. section 17-1-803 (1977 and Supp. 1982); see also William M. Fletcher, revised by Cora Thompson, *Cyclopedia of the Law of Private Corporations* (Willmette, Ill.: Callaghan, 1982), sections 4050-4052.

[3]See the Further Developments section of this feature under the heading "Sales or Exchanges and the Capital Gains Tax Exemption Under the Current and Pending Treaties" for a discussion of the treatment of gain from the sale of stock in collapsible corporations under the current Canada-U.S. income tax treaty.

[4]See supra footnote 2.

[5]Neb. Rev. Stat. section 21-20,123 (1977); Wyo. Stat. section 17-1-804 (1977 and Supp. 1982); see also Miss. Code Ann. section 79-11-17 (1972 and Supp. 1982), which provides rules for the migration of nonprofit, nonshare corporations.

and discontinuances are far from clear.[6] The GCM apparently represents the first effort to consider their U.S. income tax effects, although the subject has been alluded to in passing in some private letter rulings and, curiously enough, in the U.S. Technical Explanation of the pending Canada-U.S. income tax convention.[7]

Under the facts considered in the GCM, two Canadian provincial corporations were to be continued as Canadian federal corporations and, in addition, a Canadian federal corporation was to "migrate" to the United States by registering under the applicable continuance statute of an unidentified state in the United States. The continued corporations owned U.S. natural resource properties and the ultimate issue was whether the continuances would give rise to constructive transfers of assets or stock taxable under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA").[8] The GCM concluded that it was not necessary to determine whether any transfer of property from an "old" corporation to a "new" corporation would be deemed to occur, because Article VIII (the capital gains exemption of the existing Canada-U.S. income tax convention) would apply if such a transfer did occur and even if the corporation in question were collapsible. Nevertheless, the GCM offered some interesting comments about how corporate continuances might be characterized.

The GCM indicated that, because the continued corporation does not cease to exist but merely "migrates" to another jurisdiction, "[w]e are not convinced that any transfers of property occur as a result of these transactions." Under that view, no gain would be realized that would be subject to taxation. On the other hand, the GCM went on to point out that if the transaction were deemed to entail the transfer of assets from the continued corporation to a new corporate entity, the capital gains exemption of the treaty would apply. The GCM also raised a third possibility, referring to Revenue Ruling 72-420,[9] involving the conversion of a Netherlands "NV" into a "BV." There, the transaction was found not to involve the creation of a new entity, although a tax-free exchange of stock in the same corporation was constructed at the shareholder level.

Whether a corporate continuance is to be regarded as the transfer of assets from one corporation to another or the continuation of a single entity may be important from a U.S. income tax standpoint if it results in a change in the corporation's nationality. The place of incorporation of a company may have an important bearing on its tax treatment. For example, a corporation organized in the United States may be a member of a corporate affiliated group for purposes of filing a consolidated return while a foreign corporation usually is not.[10]

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[6] Fletcher, supra footnote 2, section 4050.

[7] "Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington, D.C. on September 26, 1980," prepared by the U.S. Department of Treasury for the Hearing Before the Committee on Foreign Relations on Various Tax Treaties, U.S. Senate, 97th Cong., 1st Sess., September 24, 1981.

[8] IRC section 897.

[9] 1972-2 CB 473.

[10] Compare IRC section 1504(b)(3) with IRC section 1504(d); see LTR 8217035, dated January 27, 1982.

A dividends-received deduction ordinarily is not allowed for dividends received from a foreign corporation but can be obtained for dividends received from domestic companies.[11] Conversely, dividends from foreign corporations may generate a foreign tax credit, although domestic dividends customarily do not have that effect.[12]

Probably the most serious result of a change in corporate nationality is its impact on the application of Code section 367. Under that provision, gain is recognized on an "outbound" transfer of appreciated property by a U.S. person to a foreign corporation, even though the transaction otherwise will qualify as a tax-free reorganization or other corporate readjustment, unless a favourable ruling is obtained from the U.S. Internal Revenue Service.[13] A ruling is not required for "inbound" transfers involving the liquidation of a foreign subsidiary into its domestic parent or the reincorporation of a foreign corporation as a domestic corporation, but the accumulated earnings of the foreign entity generally are taxable as dividends.[14] Code section 367 applies to transactions at the corporate level only if they involve a transfer of assets from one entity to another since the continuation of the same corporation does not give rise to the realization of gain.[15] Section 367 is not applicable to exchanges at the shareholder level in which the same class of stock is received in the same corporation under Code section 1036.[16] Thus section 367 would be avoided if a Canadian corporation continued in the United States or a U.S. corporation continued in Canada were treated for U.S. tax purposes as the same corporate entity.

There have been few private rulings involving continuances across national borders and they are not very helpful on this question.[17] In some of them, the transaction is treated as a constructive transfer of assets, but these rulings involved the continuation of a foreign corporation in another foreign country, resulting in no immediate tax consequences under Code section 367.[18] On the other hand, in one ruling in which the foreign corporation was continued in another jurisdiction, which was identified only as "Z," a single entity approach was followed based on the taxpayer's representation that "the continuance does not constitute the creation of a new corporate entity under Z law."[19] Under Code section 1504(d), an election is provided under which Canadian (and Mexican) corporations that are 100 per cent owned by a domestic corporation may be treated as domestic companies for purposes of U.S. income taxation, including the filing of consolidated returns. The election is regarded

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[11] Compare IRC section 243 with IRC section 245.

[12] IRC section 902.

[13] IRC section 367(a).

[14] Temp. Reg. section 7.367(b)-5(b).

[15] IRC section 367(a); LTR 8329023, dated April 15, 1983.

[16] Temp. Reg. section 7.367(b)-4(c); LTR 8329023, dated April 15, 1983.

[17] LTR 8248092, dated August 31, 1982; LTR 8146098, dated August 24, 1981; LTR 8103038, dated October 21, 1980; LTR 8052035, dated September 30, 1980; LTR 8012134, dated December 31, 1979.

[18] LTR 8103038, dated October 21, 1980; LTR 8012134, dated December 31, 1979; LTR 7927063, dated April 6, 1979.

[19] LTR 8329023, dated April 15, 1983.

by the Internal Revenue Service as an outbound transfer of property to a foreign corporation and its revocation as an inbound transfer to a domestic corporation, even though the entity remains the same.[20] It remains to be seen whether the same analysis will be applied to corporate continuances.

While the corporate laws of some of the states in the United States provide for continuances, only a few authorize discontinuances.[21] Moreover, even where a procedure exists for discontinuing a corporation so that it no longer is regarded as incorporated in the jurisdiction, the company may not choose to avail itself of the discontinuance procedure. For example, the corporation may not file the articles of discontinuance required to obtain the necessary certificate. This raises the possibility of a corporation being treated as incorporated in two jurisdictions, once in the jurisdiction in which it originally was organized and again in the jurisdiction in which it was continued.

The U.S. Technical Explanation of the pending Canada-U.S. income tax convention seems to be directed to this possibility in discussing the operation of the tie-breaker rule applicable under Article IV(3) of the treaty where a corporation is a resident of both Canada and the United States.[22] Under that provision, where a corporation is a resident of both countries, it is deemed to be a resident of the country under whose laws it was "created." The Technical Explanation indicates that Article IV(3) refers to the country of the corporation's original creation rather than the one in which it was continued because "[v]arious jurisdictions may allow local incorporation of an entity that is already organized and incorporated under the laws of another country."[23] The Technical Explanation does not specifically address the application of the tie-breaker rule under the treaty if the corporation is discontinued in the country of its original creation when it is continued in the other country; it appears, however, that in such a case it no longer will be a dual resident.

In view of the potential U.S. tax advantages of corporate continuances and discontinuances if the corporation is treated as the same entity, the issue undoubtedly will be raised more squarely and considered more fully in the future. However, the tax planning possibilities as well as the risk suggest that the subject should be kept in mind.

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[20] Temp. Reg. section 7.367(a)-1(b)(3)(iv).

[21] See supra footnote 5.

[22] Supra footnote 7.

[23] Ibid.

## FURTHER DEVELOPMENTS

*The following notes are provided to bring readers up to date on substantial developments relating to topics discussed in previous issues of the Selected U.S. Tax Developments feature.*

### "CORPORATIONS HOLDING TITLE TO REAL PROPERTY"[1]

In the July-August 1981 issue of this feature, we discussed the different treatment under Canadian and U.S. tax laws with respect to the common practice of a corporation holding title to real property as an agent or nominee for the benefit of its shareholders. U.S. tax authorities, in contrast to their Canadian counterparts, generally treat the corporation as owner of the property. In the January-February 1982 issue,[2] a subsequent case was discussed, *Roccaforte v. Commissioner,*[3] in which the U.S. Tax Court recognized the status of a title-holding corporation as an agent. The doubts expressed in that discussion as to the reliability of the decision have proved to be justified. In a recent opinion,[4] the appeals court reversed the Tax Court's decision in *Roccaforte,* holding that the corporation in question was a separate taxable entity and not a nontaxable agent or nominee.

### "'SALES OR EXCHANGES' AND THE CAPITAL GAINS TAX EXEMPTION UNDER THE CURRENT AND PENDING TREATIES"[5]

Two recent developments involve issues discussed in the article cited in footnote 5 below. First, Article XIII of the pending Canada-U.S. treaty was discussed, particularly the reference in the pending treaty to gains from the sale of "property" rather than gains from the sale of "capital assets," which is the language of Article VIII of the current treaty. A Protocol, signed June 14, 1983, modified paragraph 9 of Article XIII of the pending treaty (which reduces the gain subject to the tax in the case of property held on September 26, 1980 to the extent of the appreciation in value prior to December 31 of the year in which the treaty enters into force) to include one reference to "capital asset." As modified by the recent Protocol, paragraph 9 will provide that it applies "[w]here a person who is a resident of a Contracting State alienates a *capital asset*. . ." (emphasis added). This reinforces the suggestion in our earlier discussion that Article XIII of the pending treaty

> possibly may have been intended to divorce the new treaty exemption from the "capital gains" concept under internal law. Thus the exemption [of gains from the sale of "property"] arguably extends to gains from the sales of stock of collapsible corporations [except in the case of a "United States real property interest" under Article XIII(3)(a) of the pending

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[1] Ronald A. Morris (July-August 1981), 29 *Canadian Tax Journal* 561-63.

[2] Ronald A. Morris, "Corporations Holding Title to Real Property–Revisited So Soon" (January-February 1982), 30 *Canadian Tax Journal* 121-23.

[3] 77 TC 263 (1981).

[4] *Roccaforte v. Commissioner,* 83-2 USTC ¶9452 (5th Cir. 1983).

[5] Herbert H. Alpert (May-June 1982), 30 *Canadian Tax Journal* 454-57.

treaty] even though they result in ordinary income under the [U.S. Internal Revenue] Code."[6]

A second recent development is the publication of GCM 38989,[7] dated January 14, 1983, and related Letter Ruling 8320031, dated February 15, 1983, relating to Article VIII of the current Canada-U.S. treaty, which exempts from U.S. tax "[g]ains derived...from the sale or exchange of capital assets..." provided the taxpayer has no permanent establishment in the United States. The Internal Revenue Service ruled that gain from the sale of stock of a collapsible corporation, even though taxable under current U.S. internal law as ordinary income, was exempt from U.S. tax under Article VIII. Although the holding of the GCM and the Ruling is clear, the rationale is not clearly stated; the holding seems to be based on the fact that the collapsible corporation provision of U.S internal law was not intended to change the character of the stock of a collapsible corporation from a capital asset to a noncapital asset. While Canadians should be aware of the position of the Service set forth therein, because it would seem that the holding cannot be cited as precedent by taxpayers,[8] a Canadian confronting a similar situation under the current treaty should consider obtaining a ruling of the Service addressed to his specific situation.

## DEBT-EQUITY REGULATIONS WITHDRAWN

Earlier issues of this feature covered the U.S. Treasury Department's efforts to develop regulations under section 385 of the Internal Revenue Code to distinguish between shareholder debt and equity and the difficulties encountered in seeking to do so.[9] As outlined in the previous articles, the Treasury issued final regulations but, by extending their effective date several times, did not implement them; in the meantime, a new set of proposed regulations was promulgated in response to widespread criticism of several provisions in the final regulations.

On July 1, 1983, the Treasury withdrew the proposed regulations, proposed to withdraw the final regulations, and asked for public comment about the future of the regulations project.[10] Options mentioned in the past have included terminating the project and requesting Congress to repeal section 385, issuing a new set of regulations that essentially restate the broad guidelines contained in

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[6]Ibid., at 457.

[7]Tax Notes, June 6, 1983, at 881.

[8]See footnote 1 of the article in this feature by Stanley Weiss, "Corporate Continuances: Can They Be Used to Avoid U.S. Taxation on Transfers of Assets Between U.S. and Canadian Corporations?"

[9]See this feature, Further Developments, "Implementation of Debt-Equity Regulations Delayed" (September-October 1982), 30 *Canadian Tax Journal* 779; Stanley Weiss, "Implementation of Debt-Equity Regulations Delayed" (May-June 1982), 30 *Canadian Tax Journal* 467; Stanley Weiss, "New Proposed Debt-Equity Regulations Issued by U.S. Treasury" (January-February 1982), 30 *Canadian Tax Journal* 123-24; Stanley Weiss and Philip A. McCarty, "Summary of Final Regulations on Treatment of Certain Interests in Corporations as Stock or Debt" (March-April 1981), 29 *Canadian Tax Journal* 239-45; Stanley Weiss and Philip A. McCarty, "Summary of Proposed Regulations for Distinguishing Between Corporate Debt and Equity" (July-August 1980), 28 *Canadian Tax Journal* 524-28.

[10]See *Daily Tax Report*, No. 128 (Washington, D.C.: Bureau of National Affairs, July 1, 1983), at J-1.

the statute, or revising the proposed version of the regulations to simplify them and to add safe harbours for small business. At a hearing before the U.S. Internal Revenue Service on August 18, 1983, the American Bar Association and the American Institute of Certified Public Accountants, representing tax attorneys and accountants respectively, opted for a simplified revision that would utilize the same conceptual approaches as the regulations that have been withdrawn. Business groups, on the other hand, testified in favour of terminating the regulations project and pressing for repeal of section 385.[11] No decision apparently has yet been made by the Treasury as to the course to be followed.

## "RECENT PROCEDURAL CHANGES TO U.S. TAX LAW"[12]

In an earlier issue of this feature, we discussed the recently enacted U.S. withholding system under which "interest" or "dividends" were to be subject to withholding at a rate of 10 per cent. Originally, this system was to have been generally effective for payments made after June 30, 1983, but its effective date was subsequently postponed to payments made after August 5, 1983. In the last issue of this feature,[13] we brought to your attention the likelihood that this withholding system would be either repealed or modified. On August 5, 1983, the withholding system was repealed effective as of the close of June 30, 1983[14] and the prior "backup" withholding system was modified.

"Backup" withholding is much more limited in scope than the repealed 10 per cent withholding system. The backup withholding rate is 20 per cent on payments of "interest" and "dividend." Backup withholding is imposed if (1) the payee fails to furnish a taxpayer information number in the required manner; (2) the Internal Revenue Service notifies the payer that the payee furnished an incorrect taxpayer identification number; (3) the Service notifies the payer that backup withholding should be commenced where the payee fails to report properly interest or dividends; or (4) when required to do so, the payee fails to certify properly that the payee is not subject to backup withholding.[15]

Backup withholding is effective for payments made after December 31, 1983.[16] Penalties may be imposed on payers who fail to deduct or withhold in accordance with this system.[17] As can be seen, backup withholding has a much more limited impact on foreign as well as U.S. persons than did the repealed 10 per cent withholding system.

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[11] See *Daily Tax Report*, No. 161 (Washington, D.C.: Bureau of National Affairs, August 18, 1983), at G-1.

[12] Richard G. Fishman (January-February 1983), 31 *Canadian Tax Journal* 108-26.

[13] Further Developments (May-June 1983), 31 *Canadian Tax Journal* 509.

[14] Interest and Dividend Tax Compliance Act of 1983, Pub. L. no. 98-67 ("IDTCA").

[15] Internal Revenue Code of 1954 ("IRC"), section 3406(a); IDTCA section 104(a).

[16] IDTCA section 110(a).

[17] IRC section 6676; IDTCA section 105.